Supreme Court, U.S.
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No. 97-868

IN THE
SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1997

NACCO Industries, Inc.,
Petitioner,

v.

ROGER W. TRACY, TAX COMMISSIONER OF OHIO,
Respondent.

On Petition for Writ of Certiorari to the Supreme Court of Ohio

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RESPONDENT'S BRIEF IN OPPOSITION

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QUESTIONS PRESENTED

Ohio's Corporate Franchise Tax considers both gains and losses on the sale of federal obligations but excludes from consideration both gains and losses on the sale of state obligations in the calculation of net income base. This case presents the following questions:

1. Whether the above provisions of Ohio's corporate franchise tax violate 31 U.S.C. §3124(a). .

2. Whether Congress has comprehensively defined the scope of immunity for federal obligations from state taxation in the enactment of 31 U.S.C. §3124(a).

3. Whether the factual finding by the Ohio Supreme Court that NACCO failed to establish that the challenged franchise tax provisions discriminated against federal obligations was without evidence to support it.

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STATEMENT

In its petition, NACCO mischaracterizes both the decision by the Ohio Supreme Court and the challenged franchise tax provisions, to argue that a substantial federal question is presented. A fair reading of the decision and statute however establishes no case worthy of certiorari review. No conflict exists with state or lower appellate court rulings, and no conflict exists with decisions of this Court, or the statutory scheme involved. No national issue of importance is presented; only three states are identified as having a similar taxation method.

Most notably for purposes of this Court's consideration of whether to grant the petition, the Ohio Supreme Court held that NACCO had "failed to establish that the franchise tax discriminates against the federal government or those with whom it deals." App. 11a. The Ohio Supreme Court so held on the basis of the testimony of NACCO's own expert witness regarding the effect of the entire statutory provision which considers not only gains but also losses from sales of state and federal obligations.

Additionally, applying the plain language of 31 U.S.C. §3124(a), the court held that the immunity granted by Congress extended only to state taxation which would require the federal obligation or the interest on the federal obligation to be considered in the computation of the tax. App. 4a. Contrary to NACCO's statement, the court did not so hold because it determined that its construction of section 3124(a) was compelled by this Court's decision in *Nebraska Department of Revenue v. Lowenstein*, 513 U.S. 123 (1994). Instead, the Ohio Supreme Court determined that its holding was compelled by the plain language of the statute, noting that it expressly referred only to federal obligations and the interest on such obligations, and contained no reference to gains on the sale of such obligations.

Finally, the Ohio Supreme Court simply followed the heedings of this Court that when Congress has acted in the area of intergovernmental immunity by establishing an exemption from state taxation or regulation a court should give substantial deference to Congress and not expand such immunity beyond that clearly established by Congress. See *North Dakota v. United States*, 495 U.S. 423, 435 (1990); *Rockford Life Insurance Co. v. Illinois Dept. of Revenue*, 482 U.S. 182, 191-192 (1987); *Washington v. United States*, 460 U.S. 536, 546 (1983); *United States v. Detroit*, 355 U.S. 466, 474-475 (1958). As a result, the Ohio Supreme Court held that the Ohio franchise tax provisions which considered both gains and losses on the sale of federal obligations in the net income base measure but excluded consideration of both gains and losses on the sale of state obligations in that measure did not violate that doctrine.

REASONS THE PETITION SHOULD BE DENIED

This case does not present any issues which warrant review by this Court. It is simply a case involving one taxpayer's challenge to a $116,202.58 franchise tax imposed pursuant to a state tax provision which the taxpayer asserted but failed to establish discriminated against federal obligations. The decision below by the Ohio Supreme Court is not in conflict with any decisions of other state courts of last resort, United States Courts of appeal, or this Court. Nor is the decision below in conflict with the provisions of 31 U.S.C. §3124.

A. The Decision Below Does Not Present A Substantial Federal Question; Instead It Involves The Failure By NACCO To Present Evidence Establishing Its Claim Of Discrimination.

This case does not present a substantial federal question that demands this Court's review. Instead, it involves the application by the Ohio Supreme Court of the plain language of a federal statute, 31 U.S.C. §3124(a), by which Congress comprehensively declared the scope of immunity from state taxation provided federal obligations, and the established precedents of this Court regarding intergovernmental immunity. Ultimately, it involves a factual determination by the Ohio Supreme Court that the evidence failed to establish that the challenged statutory scheme discriminated against the federal government or those with whom it deals. As a result of this factual finding, NACCO's challenge to the franchise tax would have been rejected even if all of its legal arguments regarding the scope of the statutory and constitutional immunity provided to federal obligations were accepted. For this reason alone, this case does not merit review by this Court.

In the context of federal obligations, this Court has stated the nondiscrimination rule as follows:

> . . . a tax generally does not violate the constitutional immunity if it does not discriminate against holders of federal property or those with whom the Federal Government deals.

Memphis Bank & Trust Co. v. Garner, 459 U.S. 392,397.

Moreover, because the nondiscrimination rule of the intergovernmental immunity doctrine is based upon the principle that the states cannot obstruct the activities of the federal government, *North Dakota v. United States*, 495 U.S., at 437-438, in considering NACCO's discrimination claim the Ohio Supreme Court properly focused on the effect of the challenged franchise tax provisions on the activity of the federal government involved - the exercise of the borrowing power through the sale of federal obligations. App. 9a - 10a.

Based upon the evidence, the Ohio Supreme Court held that NACCO had failed to establish that the challenged tax provisions effected a discrimination against federal obligations. Presented with the undisputed fact that under the Ohio franchise tax provisions both gains and losses from the sale of federal obligations are considered in computing the net income base while neither gains nor losses from the sale of state obligations are considered in the computation, NACCO's expert witness testified that he could not give an opinion on whether such a scheme would have an effect on the marketability of federal obligations or, if it would, whether the effect would be a positive or a negative one.[1] NACCO's expert could not give such an opinion because while the exclusion of gain from the sale of state obligations

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[1] Unlike NACCO, the Ohio Supreme Court observed this Court's admonitions that a state tax scheme is not discriminatory simply because it treats those who deal with the federal government differently, and that a determination whether a tax is discriminatory must be based upon a review of the whole tax structure. *Washington v. United States*, 460 U.S., at 542. Throughout its argument, NACCO consciously focuses solely on that part of the franchise tax provision that deals with gain, and ignores that part that deals with losses.

but not federal obligations would, in his opinion, place some disadvantage on federal obligations in the marketplace, the required add back of losses from the sale of state obligations but not federal obligations would, in his opinion, have the reverse effect - it would place federal obligations at an advantage in the market, a fact which NACCO studiously ignores.

B. The Decision Below Does Not Conflict With The Decision Of Another State Court Of Last Resort Or A United States Court Of Appeals.

The decision of the Ohio Supreme Court is not in conflict with the decision of another state court of last resort or a United States court of appeals. The only decision which NACCO portrays as in conflict with the decision of the Ohio Supreme Court is *Doneski v. Comptroller of the Treasury*, 605 A. 2d 649 (Md. Ct. Spec. App. 1992), *cert. denied* 506 U.S. 1054 (1993). That lone decision is not a sufficient reason to grant review.

Initially, that decision was issued by an intermediate state court of appeals, the Maryland Special Court of Appeals. Moreover, the decision simply does not present a conflict. *Doneski* involved the imposition of Maryland's personal income tax on gains from the sale of federal obligations. More importantly, the statutory scheme under review in *Doneski* did not include a provision requiring that losses on the sale of state obligations be added back to the base on which the income tax was imposed. Thus, the scheme was materially different than the Ohio franchise tax provisions at issue herein. That is, perhaps, the reason that the state did not address the issue of discrimination in *Doneski*.

C. The Decision Below Does Not Conflict With The Decisions Of This Court.

1. The Decision Below Did Not Misinterpret *Nebraska Department of Revenue v. Lowenstein*, 513 U.S. 123 (1994).

NACCO states that the Ohio Supreme Court rejected its argument that the franchise tax provisions violate 31 U.S.C. §3124 because the court believed that *Nebraska Department of Revenue v. Lowenstein*, *supra*, compelled its construction of that statute (Pet. At 8), and then proceeds to urge this Court to grant certiorari to correct what NACCO claims was a fundamental misinterpretation of *Lowenstein* by the Ohio Supreme Court. The basic flaw in this argument is that it is based upon an erroneous premise. NACCO grossly overstates the reliance placed on *Lowenstein* by the Ohio Supreme Court. That court did not state or even imply that its construction of section 3124(a) was compelled by *Lowenstein*.

Clearly, *Lowenstein* was cited by the Ohio Supreme Court simply to note that like the transaction generating the income in *Lowenstein*, the transaction in this case - the sale of federal obligations from the purchaser, NACCO, to a private party - was one between private parties; the income was not, therefore, attributable to the contractual relationship between NACCO and the federal government arising out of NACCO's purchase of the federal obligations from the federal government. This distinction between transactions whereby the owner of a government obligation sells it to a private party and those for the purchase of the obligation from the government in which the government contracts to pay interest was the very same distinction relied on in

Willcuts v. Bunn, 282 U.S. 216, 227 (1931), as the basis for rejecting an intergovernmental immunity challenge to a federal tax imposed on gains from the sale of state obligations.[2]

In any event, the Ohio Supreme Court held that section 3124(a) did not extend immunity to gains from the sale of federal obligations, not because it felt that such a construction was compelled by *Lowenstein*, but by the clear language of the statute. App. 4a.

2. The Decision Below Does Not Conflict With *Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392 (1983).

Memphis Bank & Trust Co. is inapposite because the challenged state tax was imposed on interest on federal obligations, not on gains from the sale of such obligations. That case involved a challenge under 31 U.S.C §742 (replaced without substantive change by 31 U.S.C. §3124(a)) to a Tennessee bank tax imposed on net earnings of banks, including interest received on federal obligations but not interest received on Tennessee obligations. 31 U.S.C. §742 was clearly applicable because it (like its successor, section 3124(a)) expressly included within its scope every form of state taxation that would require interest on federal obligations to be considered. The specific issue in *Memphis*

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[2] Although *Willcuts* involved a federal tax imposed on the gain from the sale of state obligations, the same reasoning was applied to both federal and state tax immunity. See, *e.g.*, *South Carolina v. Baker*, 485 U.S. 505, 518 (1988).

Bank & Trust Co. was not whether the tax fell within the scope of the statute, but whether it fell within the exception for nondiscriminatory franchise taxes set forth in the statute.

Memphis Bank & Trust Co. was decided solely under the statute. The statute does not, however, include gains from the sale of federal obligations within its scope. As a result, the statute, including the nondiscrimination provision, is inapplicable. Therefore, *Memphis Bank & Trust Co.* is wholly inapposite.

D. The Decision Below Does Not Conflict With The Language Of 31 U.S.C. §3124(a).

A review of 31 U.S.C. §3124(a) demonstrates that the holding by the Ohio Supreme Court that the franchise tax provisions do not violate that statute is unassailable:

> (a) Stocks and obligations of the United States Government are exempt from taxation by a State or political subdivision of a State. The exemption applies to each form of taxation that would require the obligation, the interest on the obligation, or both, to be considered in computing a tax, except --
>
> > (1) a nondiscriminatory franchise tax or another non property tax instead of a franchise tax, imposed on a corporation; and
> >
> > (2) an estate or inheritance tax.

Contrary to NACCO's assertion, section 3124(a) does not extend the exemption from state taxation to gains realized from the sale of federal obligations. By the plain language

of the statute, the exemption is extended to "the obligation" and "the interest on the obligation." It contains no mention of gains.

Had Congress intended the exemption to extend to gains from the sale of federal obligations it would have expressly so provided. See *California State Bd. of Equalization v. Sierra Summit, Inc.*, 490 U.S. 844, 854 (1989). Interest on an investment is clearly understood as a distinct item from gain realized from a sale of that investment. This distinction between interest and gain was the basis of the ruling in *Willcuts v. Bunn*, 282 U.S., at 227, upholding against an intergovernmental immunity challenge a federal tax imposed on the gain from the sale of state obligations.

Further demonstrative of the lack of substance in NACCO's assertion is the fact that in former 31 U.S.C. §742 and §742a, as amended in 1959 by Publ. L. 86-346, 73 Stat. 622, 624, Congress included only the language "obligations or the interest thereon" in defining the scope of the exemption from state taxation (§742), but included not only "interest upon" but also "gains from the sale" of federal obligations in the immediately following section (§742a) which dealt with federal taxation. The same is true in current 31 U.S.C. §3124(a) and (b). Subsection (a), which deals with state taxation, refers only to interest while subsection (b), which deals with federal taxation, refers not only to interest but also to earnings and other income and to gain from the sale of federal obligations.

The legislative history of the 1959 amendment to Rev. Stat. §3701, as so amended, 31 U.S.C. §742 (86th Congress, H.R. 9035) further evidences that Congress expressly referenced gains when it intended that they be included within the scope of the provision. Part II.D. of the Senate

report, which explained the section of the bill regarding the exemption from state taxation, referred only to interest; it contains no mention of gains. U.S. Cong. & Adm. News, 86th Congress, 1st Session 1959 (2), 2769, 2773-4. The immediately following part of the Senate report (II.E.), discussed a section of the bill which provided for the nonrecognition of gain or loss on certain exchanges of United States obligations for new United States obligations. *Id.* at 2774. This demonstrates that Congress was fully cognizant of the separate concepts of interest and gains when they amended Rev. Stat. §3701, because in the very same bill Congress addressed and amended another statute which dealt specifically with the treatment of gains from federal obligations. Given Congress' obvious awareness of this distinction, the absence of any inclusion of "gain" in Rev. Stat §3701 can only be presumed to be intentional. *Chicago v. Environmental Defense Fund*, 511 U.S. 328, 338 (1994), citing *Keene Corp. v. United States*, 508 U.S. 200 (1993). Accord, *Rodriquez v. United States*, 480 U.S. 522, 525 (1987).

Congress has not expressed any intent to include gains from the sale of federal obligations within the comprehensive grant of immunity from state taxation provided by 31 U.S.C. §3124(a). The specific language used by Congress does not even imply such an intent. This clearly expressed intent should not be expanded or modified by the courts. *Rockford Life Insurance Co. v. Illinois Dept. of Revenue*, 482 U.S., at 191-192; *Graves v. New York ex rel. O'Keefe*, 306 U.S. 466, 479 (1939). As *Rockford Life Insurance* cautions:

> A court must proceed carefully when asked to recognize an exemption from state

> taxation that Congress has not clearly established.

482 U.S., at 191.

NACCO attempts to avoid the fatal impact of the absence of any reference to gain in section 3124(a) by engaging in a tortured construction of the language in that provision. NACCO argues that a tax which considers gains on the sale of federal obligations in its computation is a tax which considers the obligation in its computation. On its face, this argument is fallacious. A tax which considers the gain does just that, it does not consider the obligation in the computation.

NACCO's construction is also rebutted by the very language relied upon. That language states that a tax falls within the exemption if it requires the obligation or the interest on the obligation to be considered. Under NACCO's construction, there would be no reason to include interest within the provision because if the general reference to obligations included a prohibition on considering gain it would certainly prohibit a consideration of interest. The separate inclusion of interest in the language of the provision conclusively negates any argument that the term "obligation" was intended to include anything other than the principal of the obligation.

Thus, the absence of any prohibition on the inclusion or consideration of gains from the sale of federal obligations is not at all puzzling. As *Willcuts v. Bunn*, 282 U.S., at 232, noted, the taxation by states of gains on the sale of federal obligations had not historically been a concern of the federal government. It is not a concern of section 3124(a).

E. No Question Of National Importance Is Presented; Any Concerns Portended By NACCO Regarding The Marketability Of Federal Obligations Can Best Be Addressed By Congress.

NACCO asserts that a substantial national question is presented, but cites to only two other states that have a similar taxation methodology to Ohio. And this case involves only one taxpayer, seeking approximately $116,000. If this were ever a proper issue for certiorari, it is one that needs further development before it is worthy of this Court's review.

NACCO's argument that this case presents issues that have serious implications for the ability of the federal government to borrow money through the sale of its obligations (Pet. at 20-21) is based wholly upon assertions that are simply in conflict with the evidence. As detailed earlier, NACCO's own expert witness could not testify that the challenged franchise tax provisions would place federal obligations at a market disadvantage. Dr. Buser admitted that he could not give an opinion as to whether the difference in the treatment of gains and losses from the sale of federal as opposed to state obligations would make federal obligations more attractive or less attractive to an investor. NACCO's statement that the federal government would have to offer higher interest rates is likewise unsupported because it is based solely upon the erroneous assertion of a demonstrated market disadvantage for federal obligations.

In all events, NACCO's claims of adverse consequences to the ability of the federal government to market its obligations ignores a fundamental fact. If Congress determines that such statutory schemes would burden or obstruct the federal government's ability to market

federal obligations, it has the unquestioned power to alleviate any such concern by the simple expedient of amending section 3124(a) to prohibit the consideration of gains from the sale of federal obligations under such statutory schemes.

Moreover, in the absence of a mandate in the Constitution or in section 3124(a), it should be left to Congress to address any perceived adverse consequences regarding the marketability of federal obligations. As this Court has noted, deference should be given to Congress to determine the scope of intergovernmental immunity because Congress is best qualified to resolve the delicate balancing of the competing demands of the respective governments. *North Dakota v. United States*, 495 U.S., at 435; *Washington v. United States*, 460 U.S., at 546; *United States v. Detroit*, 355 U.S., at 474. Congress is in the best position to determine whether or to what extent a state tax scheme would burden or obstruct an activity of the federal government - such as the exercise of the borrowing power - and, if so, whether the situation calls for Congressional action.

CONCLUSION

For the foregoing reasons, the Court should deny the petition for a writ of certiorari.

Respectfully submitted,

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